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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962
No. 723

MEL DAR CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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COMMISSIONER OF INTERNAL REVENUE,

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Mel Dar Corporation petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in the above-entitled case.[1]

Opinions Below.

The Tax Court's findings of fact and opinion were not officially reported, but are contained in the printed record [R. 191-260, 262-265]. The opinion of the court of appeals (App. A, *infra*, pp. 1-22) has not yet been officially reported.

[1]Because of certain common questions and evidence, Mel Dar Corporation's petition for review to the Court of Appeals was consolidated for purposes of printing the record, briefing and argument with the petitions for review filed by Coy Burnett and Mildred K. Burnett, and the Court of Appeals filed a single opinion disposing of such consolidated petitions. However, this petition seeks review of two questions affecting Mel Dar Corporation alone.

Jurisdiction.

The judgment of the court of appeals was entered on October 27, 1962 (App. A, *infra*, p. 23). A petition for rehearing was denied on December 5, 1962 (App. A, *infra*, p. 23).[2] The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254(1).

Questions Presented.

1. Under the "all events" test, an accrual basis taxpayer could not deduct certain oil expenses in the tax year it paid them, because in an action against taxpayer's lessor a Texas jury had found another to be the lawful lessee, and the taxpayer had then intervened, claiming reimbursement for such expenses as a good-faith improver. Two years later, the reimbursement question became moot when the judgment for the other lease claimant was reversed on appeal. Were such expenses deductible in the year such final event fixing liability for such expenses occurred; or, as held by the Court below, did such expenses retroactively become deductible only in the year of payment?
2. Are such taxpayer's legal expenses of attempting to recover monies which would be income rendered non-deductible simply because instead of bringing a separate action for reimbursement it intervenes in the primary title action prior to judgment to avoid circuity of action under Texas procedure?

[2] The questions raised herein are those presented to the Court of Appeals in the petition for rehearing. The trial before the Tax Court and the appeal to the Court of Appeals involved other questions which are no longer in issue.

Statutes Involved.

The pertinent statutory provisions are section 23(a)-(1)(A), section 41 and section 43 of the Internal Revenue Code of 1939 (Title 26, United States Code). They are printed in Appendix B, *infra*, pp. 24-25.

Statement.

The petitioner (hereinafter called the taxpayer or Mel Dar) is a family corporation engaged in the business of developing and operating oil properties in the State of Texas. [R. 116-117, 196].[3] Mel Dar is an accrual basis taxpayer, with a fiscal year May 1-April 30th, whose tax returns for the years in question were timely filed [R. 197].

For many years, Mr. and Mrs. Coy Burnett have owned Shamrock Island — a small island in Corpus Christi Bay, Texas [R. 196]. In late 1949, after producing oil wells were drilled on surrounding State lease parcels, it became apparent that a common oil pool underlay the area, and that Shamrock Island had a high potential for oil and gas [R. 196, 410]. In early 1950, the Burnetts' negotiations for an oil lease with Mar-Tex Realization Corporation (hereinafter called Mar-Tex) in Los Angeles collapsed [R. 119]. However, Mar-Tex filed suit against the Burnetts in Texas, contending that the negotiations had resulted in a lease or a contract to make a lease [R. 119-120, 196]. After the Burnetts unsuccessfully attempted to obtain another Texas lessee, and in the face of the continuing deple-

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[3]The relevant facts, which are all undisputed, are contained in the Tax Court's memorandum findings of fact [R. 191, 196-216], supplemented by the parties' stipulation of facts [R. 115-173] found by the Tax Court [R. 196].

tion of the oil pool by adjoiners, the Burnetts leased Shamrock Island to their reorganized family corporation, Mel Dar [R. 197-198].

Thereafter, Mel Dar physically paid $111,790.64 for necessary oil development expenses during its tax year ending April 30, 1951 [R. 128-129, 207], upon its lawyers' advice that Mar-Tex would be obligated to reimburse Mel Dar therefor under the Texas law of cotenancy should Mar-Tex prevail in its action against the Burnetts [R. 330-331, 300].

In November, 1950, the week a Texas jury found that Mar-Tex was entitled to a lease from the Burnetts, the first Mel Dar oil well on Shamrock Island began producing [R. 122]. Other wells were then drilled [R. 123-125].

On April 30, 1951 (the last day of its fiscal year), six months after the jury trial of the lease question, Mel Dar intervened in the *Mar-Tex v. Burnett* action as favored by Texas procedure, claiming reimbursement of its oil expenses from Mar-Tex — the adjudicated lessee—and enhancement in the value of the leasehold [R. 198; Ex. 30-DD]. Following a two week trial [R. 122], Mel Dar's claim for reimbursement was allowed in the sum of $513,000 (including the $111,790.64) by the final judgment on August 1, 1951 [R. 131]. The Burnetts appealed from the judgment that Mar-Tex was entitled to a lease, and Mel Dar appealed from the denial of enhancement value damages (App. A, *infra*, p. 6).

Thus, on October 15, 1951, the due date for filing Mel Dar's return for its fiscal year ended April 30, 1951 [R. 131], Mel Dar's right to reimbursement under

Texas law of the oil expenses physically paid in that year had been judicially confirmed. Therefore, Mel Dar reported all the facts to the Commissioner in its return, stating that "None of the income from production during the fiscal year nor any of the expenses incurred in development and operation of the property are being reported for income tax purposes pending a determination of the rights of the respective parties . . ." [Ex. 1-A].

In June, 1952, the Texas Court of Civil Appeals reversed the judgment that Mar-Tex was entitled to a lease. *Coy Burnett et al. v. Mar-Tex Realization Corporation*, 250 S. W. 2d 612. Subsequently, the Texas Supreme Court denied a hearing and a rehearing, and on December 17, 1952 (Mel Dar's fiscal year 1952-1953), the reversal became final [R. 197]. The reimbursement issue thus became moot.

Mel Dar necessarily incurred or paid legal expenses in connection with the Mar-Tex suit. The Commissioner disallowed $24,589.80 paid by Mel Dar in the prosecution of its complaint in intervention, and the $15,000 Mel Dar accrued on its books during its fiscal year ended April 30, 1953 for attorneys' fees on the appeal [R. 208-209]. Although the record of the Burnetts' and Mel Dar's legal expenses were kept jointly; after the two *Mar-Tex* trials, such expenses were divided—the expenses of the title action being allocated to and paid by the Burnetts, and the expenses of the reimbursement trial being allocated to Mel Dar [R. 164-170]. Such allocation was well documented by invoices, statements and vouchers [R. 352-353; Ex. 47-1 through 47-99; Ex. 48; and Ex. 49]. Later, in 1956, a Texas jury awarded the attorneys who jointly repre-

sented Mel Dar and the Burnetts on the *Mar-Tex* appeal $80,000, which was affirmed on appeal, *Burnett et al. v. Graves*, 230 F. 2d 49, 5 Cir., 1956, and Mel Dar paid such judgment [R. 209].

The Tax Court approved the Commissioner's retroactive assignment of Mel Dar's deductible oil expense to Mel Dar's tax year ended April 30, 1951, when such expenses were physically paid, instead of to Mel Dar's fiscal 1952-1953—the year the *Mar-Tex* litigation ended—notwithstanding Mel Dar's right to reimbursement from Mar-Tex, on the assumed authority of *Consolidated Edison Co. v. United States*, 135 F. Supp. 881 (Ct. Cl.), *certiorari denied* 351 U. S. 909 (1956) and the premise that "accrual, from the debtor's standpoint, precedes payment, and does not survive it."

The Tax Court also affirmed the Commissioner's disallowance of all of Mel Dar's legal expenses of prosecuting its right to reimbursement (and recovery of income) on the theory that as a whole "the Mar-Tex litigation was primarily a title contest", and hence, that Mel Dar's expense of the second trial involving the non-title, reimbursement issue, were "corollary" to the title issue and hence capital expenditures by association [R. 230-236].

The court of appeals, notwithstanding this Court's intervening decision in *United States v. Consolidated Edison Co.*, 366 U. S. 380 (1961) rejecting the fact of physical payment as the "touchstone" of determining the year in which an item of deduction accrues, affirmed the Tax Court's holding that physical payment of expenses automatically accrued them as a deduction in the year paid. The court of appeals also approved the Tax Court's verbal aggregation of the two separate

Mar-Tex trials precedent to characterizing the entire litigation as "primarily a title contest" (App. A, *infra*, pp. 18-19).

Reasons for Granting the Writ.

1. The decision of the court below is in direct conflict with the decision of this Court in *United States v. Consolidated Edison Co.*, 366 U. S. 380 (1961), on an issue which involves substantial amounts of revenue.

a. A large portion of all corporate taxpayers use the accrual basis in recording and reporting their income and deductions. Such taxpayers pay out millions of dollars annually for improvements in the face of litigation questioning their title to land, equipment, patents and other valuable rights. Because of the amounts involved, and because of the time lag between the business necessity for such expenditures and the final judicial determination of such controversies, it is vital that there be a uniformly applied test of accruability. If, as the Court below has held, an otherwise deductible expense, initially not deductible in the year of payment under the "all events" test because of pending litigation, may many years later be retroactively held to be deductible *only* in the year of payment, the effect on the business world will be chaotic.

There are many examples in the law of payments made under practical economic duress, where, although the question is being honestly and diligently contested in the courts, the judicial determination of the final obligation for such expense is deferred for many years.

Not unnaturally, there has been a wealth of litigation as to what circumstances are critical in determining the accruability of an item of deduction. This Court alone has considered different variations of the funda-

mental question on more than half a dozen occasions. Case by case, the Court has pricked out a line between expenses which must be accrued when paid, and expenses which may not be accrued until "all events" have occurred which fix the amount of the expense and determine the liability of the taxpayer. *United States v. Anderson*, 269 U. S. 422; *Lucas v. American Code Co.*, 280 U. S. 445; *Brown v. Helvering*, 291 U. S. 193; *Dixie Pine Products Co. v. Commissioner*, 320 U. S. 516; *Security Flour Mills Co. v. Commissioner*, 321 U. S. 281; *United States v. Olympic Radio & Television, Inc.*, 349 U. S. 232.

Just prior to this Court's decision in the *Consolidated Edison* case, the lower courts were in conflict as to one facet of the question—whether physical payment of a local tax to avoid seizure pending a contest accrued such tax, or whether such tax did not accrue until final determination of the pending contest. The Court of Claims held that physical payment alone was determinative of accruability. The Second Circuit held that such a contest deferred accruability (*United States v. Consolidated Edison Co.*, 366 U. S. 380, 381).

This Court granted certiorari, and in its decision exploded the notion that "payment" of an expense required its accrual notwithstanding the pendency of an action for reimbursement.

The Court below, by adopting the Tax Court's reasoning and holding (based on the Court of Claims *Consolidated Edison* decision) has placed itself in direct conflict with this Court's clear direction that (366 U. S. 380, 391):

> "'. . . [w]hen the exact nature of the payment is not immediately ascertainable because it de-

> pends on some future event, such as the outcome of litigation, its treatment for income-tax purposes must await that event.'"

In this case, the oil pool underlying Shamrock Island was being rapidly depleted by adjoiners. Mel Dar's only legal remedy to prevent such irrevocable loss of Shamrock Island's share of such oil under the "law of capture" was to drill wells itself. *Magnolia Petroleum Co. v. Blankenship*, 85 F. 2d 553, 5 Cir., 1936, *certiorari denied*, 299 U. S. 608 (1936). Such expenditures and Mel Dar's concurrent action against Mar-Tex for reimbursement thereof preserved the integrity of the leasehold—reserving the ultimate question of liability therefor to judicial determination. The present case is thus indistinguishable from the Court's holding in *Consolidated Edison*.

b. Even had this Court not so clearly negated the equation of "payment" alone with accruability, reason and modern accounting principles point the same way. Unlike the cash—basis taxpayer, accrual accounting demands that an accrual—basis taxpayer not accrue an item as an "expense" when serious litigation as to liability therefor is pending. Instead, such a contingent item is properly recorded as an "asset"—a deposit which is expected to be recovered—pending the outcome of the litigation. *Consolidated Edison Co. v. United States*, 279 F. 2d 152, 2 Cir., 1960, fn 4, p. 157. Here Mel Dar so recorded its oil expense on its books, and so advised the Commissioner in 1951 [Ex. 1-A], who did not challenge such method until September, 1957—almost 6 years later.

2. The decision of the court below is in conflict with the decisions of other circuits,[4] notably *Levy v. Commissioner*, 212 F. 2d 552, 5 Cir., 1954, which hold that ". . . It is well-settled that expenses for which there exists a right to reimbursement are not ordinary and necessary business expenses . . ." (212 F. 2d 552, 554).

Here, during its fiscal year 1950-1951, Mel Dar had a right to reimbursement of its expenses as a good-faith improver under Texas law, following the November, 1950 jury verdict that Mar-Tex was the lawful lessee. Such right was judicially confirmed after the end of such fiscal year, but before the tax return was due. Mel Dar could not and did not claim such expense as a deduction because as of the close of its taxable year, it was entitled to reimbursement.

The court of appeals made the same error the Tax Court did in assuming that Mel Dar's right to reimbursement was "contingent" and merely a "possibility". Under Texas law, Mel Dar, as a goodfaith improver, was clearly entitled to reimbursement if Mar-Tex prevailed. *Shell Oil Co. v. Howth*, 138 Tex. 357, 159 S. W. 2d 483; *Yates v. Gulf Oil Corp.*, 182 F. 2d 286, 5 Cir., 1950. The jury verdict that Mar-Tex was the lawful lessee was "final" (and not "contingent") unless and until set aside or reversed, *Long v. Martin*,

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[4] *Universal Oil Products Co. v. Campbell*, 181 F. 2d 451 (C. A. 7), certiorari denied 340 U. S. 850; *Glendinning McLeish & Co. v. Commissioner*, 61 F. 2d 950 (C. A. 2d), affirming 24 B. T. A. 518; *Island Petroleum Co. v. Commissioner*, 57 F. 2d 992 (C. A. 4), affirming 17 B. T. A. 1, certiorari denied 287 U. S. 646; *Smith v. United States*, 135 Fed. Supp. 694 (D. N. J.); *Estate of Elmer B. Boyd*, 28 T. C. 564; *Richard M. Drachman*, 23 T. C. 558; *Standard Oil Co. of New Jersey*, 7 T. C. 1310.

260 S. W. 327, err. dis. 114 Tex. 581, 278 S. W. 1115 (*cf. Chesapeake & O. R. Co. v. McCabe*, 213 U. S. 207). Entry of the final trial court judgment for reimbursement prior to the due date for Mel Dar's return confirmed the right to reimbursement.

3. The decision below leaves accrual—basis taxpayers on the horns of a cruel dilemma—they cannot accrue and claim an out-of-pocket expense as a deduction when paid if a right to reimbursement exists and is being litigated; however, their subsequent claim to a deduction may be barred by later events. We respectfully suggest that the hindsight afforded by later events used by the courts below introduces a concept disapproved by this Court on more than one occasion. *Spring City Foundry Co. v. Commissioner*, 292 U. S. 182 (1934).

4. The decision of the court below holds that the legal expenses of a severable non-title issue, tendered by a complaint in intervention under the same caption as a threshold title issue, as favored by Texas procedure (*Murphy v. Benson*, 245 S. W. 249; *Mulhelland v. Jolly*, 17 S. W. 2d 1109; *Jenkins v. Pure Oil Co.*, 53 S. W. 2d 497; 30 Tex. Jur. 2d 327-328; 42 C. J. S. 432, 452), but separately tried *after* the threshold title issue was adversely decided, are non-deductible capital expenditures by mechanical application of the "primary purpose" rule. Such holding begs the real question of whether deductibility should so turn on the form of the action, instead of on substance *Kornhauser v. United States*, 276 U. S. 145. In addition it is in conflict with decisions in other Circuits (*e.g. Helvering v. Stormfeltz*, 142 F. 2d 982, 984, 8 Cir., 1944) and the Tax Court (*William A. Falls*, 7 T. C. 66, 72, 1946; *Estate of*

Thomas E. Arnett, 31 T. C. 320, 334-335, 1958), holding that where the legal costs of litigating both title and non-title issues in one action are capable of separation, the latter are deductible. See: 74 Harv. L. Rev. 1409, 1419. In this area, as in the area of personal rights, the concept of "guilt by association" is a pernicious doctrine.

The decision below sets a dangerous precedent, in that there is a definite trend to the separate trial of the issues of liability and damages in substantial cases. Under the decision below otherwise deductible legal expenses of pursuing income items will be denied deductibility, on the theory that the action is "primarily a title suit", even though such expenses are clearly and easily separable.

5. The decision below presents yet another facet of the question of deductibility of legal expenses which are capable of allocation or separation from legal expenses classed as capital expenditures, as to which this Court has recently granted certiorari to resolve the conflict between the lower courts: *United States v. Gilmore*, No. 21, October Term, 1961; *United States v. Patrick*, No. 22, October Term, 1961.

While the number of cases involving the allocation of corporate legal expenses when capable of segregation is perhaps not as large as those involving domestic relations, we suggest that their impact on the revenue is, if anything, greater; and that having granted certiorari on one facet of the question, the Court might favorably consider a hearing in this case designed to result in a unifying principle for the deductibility of all legal expenses.

Conclusion.

For the reasons stated, this petition for a writ of certiorari should be granted, the judgment below reversed, and the case remanded for disposition in accordance with *United States v. Consolidated Edison Co.*, 366 U. S. 380, and *Kornhauser v. United States*, 276 U. S. 145.

Respectfully submitted,

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APPENDIX A.

I. Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Mel Dar Corporation, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent., No. 17,421.

Coy Burnett and Mildred K. Burnett, Petitioners, vs. Commissioner of Internal Revenue, Respondent, No. 17,422.

Coy Burnett and Mildred K. Burnett, Petitioners, vs. Commissioner of Internal Revenue, Respondent, No. 17,423. Oct. 27, 1962.

On Petitions for Review of the Decisions of the Tax Court of the United States.

Before: Barnes, Hamley and Hamlin, Circuit Judges.

Hamlin, Circuit Judge:

Petitioners, Coy Burnett and Mildred K. Burnett, are husband and wife who duly filed joint income tax returns for the calendar years 1951 and 1952. In 1957 the Commissioner of Internal Revenue assessed deficiencies in taxes against them for 1951 in the amount of $48,160.92 and for 1952 in the amount of $78,905.72. Petitioner Mel Dar Corporation is a Nevada corporation with its principal place of business in Los Angeles, California, which is wholly owned by the Burnett family. Using the accrual method of accounting, Mel Dar duly filed its tax returns for the fiscal years 1952 and 1953 covering the period beginning with May 1, 1951 and ending April 30, 1953. The Commissioner in 1955 assessed against Mel Dar deficiencies in income and excess profits taxes in the amount of $62,772.68

for fiscal 1952 and $7,733.28 for fiscal 1953. The Burnetts and Mel Dar filed petitions in the Tax Court for redetermination of deficiencies. The petitions were consolidated for trial in the Tax Court due to common issues of fact and law. The Tax Court had jurisdiction by virtue of section 272(a) of the Internal Revenue Code of 1939. After decisions favorable to the Commissioner petitioners timely filed petitions with this court for review of the Tax Court decisions. The above entitled cases were consolidated for review. We have jurisdiction under the provisions of section 7482 of the Internal Revenue Code of 1954, 26 U.S.C.A. §7482.

In the Tax Court the parties entered into an extensive stipulation of facts. At trial the petitioners produced five witnesses and introduced certain documentary and photographic exhibits. The Commissioner offered no evidence. The Tax Court adopted the parties' stipulation of facts and then paraphrased many of them in its Memorandum Findings of Fact and Opinion. Thus, on review the facts are substantially undisputed.

At all times pertinent to this case Coy and Mildred Burnett have been owners of Shamrock Island which is about 130 acres of land located off the coast of Corpus Christi, Texas. The high potential of Shamrock Island for oil and gas production was demonstrated prior to 1950 when the Atlantic Refining Company under leases from the State of Texas began producing oil and gas from adjoining property.

In February, 1950, the Burnetts entered into negotiations with Mar-Tex Realization Corporation, hereafter Mar-Tex, for an oil and gas lease to Shamrock Island. Thereafter, the Burnetts terminated the negotiations. On April 8, 1950, Mar-Tex instituted a suit against the

Burnetts in the District Court of Nueces County, Texas, contending that it had a valid lease or contract to make a lease and praying that the Burnetts be compelled to deliver an oil and gas lease to Shamrock Island.[1] Under the terms of the lease claimed by Mar-Tex, it was entitled to possession of the property and 60% of the oil and gas produced therefrom. The Burnetts contested the Mar-Tex suit.

On May 19, 1950, petitioner Mel Dar Corporation, was incorporated in Nevada as the successor to Mel Dar Company, a family company owned by the Burnetts and their married daughters. Mel Dar Corporation was thus a closely held family corporation.

On June 5, 1950, the Burnetts entered into a lease with Mel Dar Corporation for the development of Shamrock Island for oil and gas purposes. The Burnetts as lessors in the Mel Dar lease were to receive from the lessees 25% of the gross receipts from the sales of oil and gas produced upon Shamrock Island. Financing arrangements were made with the Security National Bank of Los Angeles with whom the Burnetts had dealt over a period of many years in connection with other enterprises. The bank was kept informed of all phases of the Shamrock oil operations. As lessee, Mel Dar commenced operations for the production of oil and gas, the bank having agreed to lend Mel Dar $150,000 as of August 14, 1950.

The lease was amended on August 8, 1950, at the suggestion of the bank and it had been amended once before on July 3, 1950. These amendments provided certain changes in favor of Mel Dar. They referred to

[1]On April 12, 1950, a Notice of Lis Pendens was filed with the State court and recorded by Mar-Tex.

the Mar-Tex litigation and provided "as additional consideration" a conditional royalty of $100,000 after payment of expenses of the venture and the creation of a reserve of current assets equal to one and one-half times current liabilities. Paragraph 10 of the August 8, 1950, "Second Amended Lease" provided for the possibility of further amendments in the event "a change of any kind is deemed advisable by the parties hereto."[2]

The August 14, 1950, agreement between Mel Dar and the bank in which the bank agreed to loan Mel Dar $150,000 provided, among other things, that (1) the loan would be used solely for financing Shamrock Island oil development, (2) so long as the loan existed Mel Dar would submit its financial policy to the bank for clearance, (3) Mel Dar would not "cancel, alter or modify the leasehold estates" to Shamrock Island without the bank's consent. On the same day the Burnetts agreed to subordinate in favor of the bank all existing and future claims held by them against Mel Dar except the Burnetts' royalty under the lease as amended; however, the Burnetts agreed to lend back to Mel Dar the proceeds from their royalty from Shamrock Oil Development. Part of the $150,000 loan made by the bank was used to liquidate an existing indebtedness of ap-

[2]10. Because a claim of a prior lease to Shamrock Island presents a threat which may become a hazard whose limits cannot definitely be foreseen, and because certain rights concerning accretion, excretion and avulsion might substantially change the type of development which would be to the best interest of all parties hereto, it is hereby agreed that if a change of any kind is deemed advisable by the parties hereto, or if necessary by the arbitration herein provided by Paragraph 14 hereof, it is the agreed intention that the relative interests, advantages and disadvantages of the respective parties shall, as nearly as possible, be evaluated, retained, translated into and continue to exist in such changed programs or procedure.

proximately $60,000 which Mel Dar had obtained from the bank and had used to pay Shamrock Oil expenses and the balance of approximately $90,000 was received in cash by Mel Dar from the bank.

After some difficulty in obtaining drillers to deal with Mel Dar, Coy Burnett on September 9, 1950, entered into a contract with A. J. Bankhead Drilling Company, Inc., for the drilling of the first oil well on Shamrock Island on a cash footage basis. Mel Dar paid this expense, and the drilling of the first well began on October 5, 1950.

As the time approached when oil was expected to be produced, attempts were made to find a buyer for the oil. Atlantic Refining Company held most of the leases surrounding Shamrock Island and it was approached as a prospective buyer. Atlantic refused at first. Later, however, on October 25, 1950, Atlantic agreed to buy the oil produced on Shamrock Island in consideration of Burnetts' granting to Atlantic easements and sites on Shamrock Island for tanks and a pipeline, and upon the further condition that Atlantic could withhold and impound 60% of the proceeds in order to protect itself from any possible claim by Mar-Tex.

On October 16, 1950, before any oil had been produced and before Atlantic had agreed to purchase any oil, Mel Dar and the Burnetts made another agreement entitled "Lease Amendment" which, after reciting certain difficulties which had occurred, made certain changes in the royalty payments to be made by Mel Dar to the Burnetts. The principal change in these payments was that the Burnetts were to receive 25% of the "net profits" as defined therein instead of 25%

of the gross sales as provided for in the August 8, 1950, amendment.

The first well on Shamrock Island was completed on November 7, 1950, and the oil it produced was sold shortly thereafter to Atlantic in accordance with the agreement.

In the fall of 1950 the litigation between Mar-Tex and the Burnetts was proceeding.[3] On October 30, 1950, a jury trial commenced on the question whether there was a valid lease or contract entered into between Coy Burnett and Mar-Tex requiring Coy Burnett to execute and deliver an oil and gas lease. This was the first phase of the Mar-Tex suit. On November 7, 1950, the jury decided this issue in favor of Mar-Tex.

On April 30, 1951, Mel Dar intervened in the Mar-Tex suit claiming reimbursement for amounts expended by it in the development of Shamrock Island for oil and gas purposes and for any enhancement in the value of the leasehold. This was the second phase of the Mar-Tex suit and it was tried before the court without a jury. On August 1, 1951, the court entered judgment upon the verdict for Mar-Tex finding that it was entitled to the lease claimed, and judgment was entered for the Burnetts and Mel Dar holding that they were entitled to reimbursement for the $513,000 expended by Mel Dar up to that time for development. The court, however, denied recovery for any enhancement in the value of the lease. The Burnetts appealed the lease question and Mel Dar appealed the enhancement question.

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[3]The Burnetts had denied the claim of Mar-Tex as to its right to a lease and in addition had cross complained for reimbursement of expenses in the event that it was held that Mar-Tex was entitled to a lease.

In June, 1952, the Texas Court of Civil Appeals reversed the trial court holding that as a matter of law there was no lease or contract to make a lease.[4] The court did not reach the question of the enhancement raised in Mel Dar's appeal. The Texas Supreme Court denied an Application for a Writ of Error in November 1952, and the litigation was finally terminated when a motion for a rehearing was denied.

Pursuant to its agreement, Atlantic impounded a large sum of money (60% of the proceeds from the sale of oil) from the commencement of oil production until December, 1951. On December 18, 1951, after negotiations, Atlantic released the impounded funds to Coy Burnett upon receipt of a bond on which Burnett was the principal and on which the United States Fidelity and Guaranty Company was surety. The bond protected Atlantic in the event Mar-Tex was finally successful in its litigation. The money received from Atlantic under this arrangement was deposited by Burnett into Mel Dar's account. Subsequently, some of this money was distributed to the Burnetts as their royalty interest in the leased property. When the Mar-Tex litigation was finally determined against Mar-Tex, Atlantic released the remainder of the impounded funds to Burnett and this also was deposited in the Mel Dar account.

A number of contentions are made by petitioners relating to the determinations of the Commissioner which were for the most part approved by the Tax Court. Of necessity, they are treated separately in this opinion.

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[4] Burnett v. Mar-Tex Realization Corp., 250 S.W. 2d 612 (Tex. Civ. App. 1952).

I

The principal problem in this case relates to the October 16, 1950, amendment to the lease between the Burnetts and Mel Dar which changed the Burnetts' royalty interest from 25% of the *gross* receipts from the production of oil and gas to 25% of the *net* profits from such production. In 1954 the lease was amended to provide once again for a 25% gross royalty to the Burnetts. The Commissioner disallowed any tax vitality to the October 16, 1950, amendment and determined that the Burnetts were considered for tax purposes at all times to have been entitled to a 25% *gross* interest in the proceeds from Shamrock Island. The Tax Court approved the Commissioner's determinations of tax deficiencies arising out of the Commissioner's non-recognition of the 25% net profits amendment. The Tax Court held that the amendment lacked business purpose and was entered into solely for the purposes of shifting the incidence of taxation.

The business purpose doctrine was established by *Gregory v. Helvering*, 293 U. S. 465 (1935) *aff'g*, 69 F. 2d 809 (2d Cir. 1934). In that case the taxpayer had an elaborate scheme to take advantage of the provision in the tax code that in corporate reorganization the distribution of stock of one corporation by the other to its shareholders results in no gain to the shareholders. The scheme was designed expressly and exclusively for the purpose of taking advantage of the favorable tax provision, and although the reorganization was letter-perfect in form the Court held that the transaction could have no tax vitality for it lacked substance and business purpose (apart from the avoidance of taxes). The transaction though a "reorganization" in form was

not a "reorganization" within the meaning of the special tax provision. As the Court stated, "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."[5] The following quotation from Judge Learned Hand's *Gregory* opinion in the Court of Appeals is instructive:

> We agree with the . . . . taxpayer that a transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. . . . The purpose of the section [Internal Revenue Code of 1928 §112(g) corresponding to the present §368(a)(1)(D) of the 1954 Code] is plain enough; men engaged in enterprises—industrial, commercial, financial, or any other—might wish to consolidate, or divide, or add to, or subtract from their holdings. Such transactions were not to be considered as "realizing" any profit, because the collective interests still remained in solution. But the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate "reorganizations."[6]

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[5] 293 U.S. at 470.

[6] Helvering v. Gregory, 69 F.2d 809, 810-11 (2d Cir. 1934).

The business purpose doctrine of *Gregory* applies to all sorts of varying situations which arise under the tax statutes. It serves as a constant reminder that business transactions must have some purpose other than the mere avoidance of taxes.[7]

We believe there is substantial merit to the petitioners' contention that under all the circumstances of this case it is clear that the change of Burnetts' royalty from 25% gross to 25% net had business purpose. In early 1950 it was imperative that the Burnetts develop Shamrock Island for oil and gas purposes immediately due to the fact that wells were operating on surrounding property and were draining oil and gas from a common underground pool. The Mar-Tex suit was instituted in which it was claimed that the Burnetts were not entitled to possession of the property and a lis pendens was filed. This made it difficult to get independent companies to develop Shamrock Island. As a result Burnetts were forced to develop the property themselves and they reformed their family corporation for this purpose. A substantial amount of capital was needed for development and large loans had to be made to Mel Dar. As a condition to Mel Dar's loans the bank involved required the Burnetts to subordinate their claims against Mel Dar to those of the bank. The Burnetts' royalties were not subordinated, however; but the Burnetts agreed with the bank to loan back to Mel Dar all proceeds received from Shamrock Island production during the development stage. In an earlier amendment to the lease it was recognized by the parties that further amendments to the lease might be necessary in order

[7] See Surrey & Warren, Federal Income Taxation, ch. 9 § 3 (1960 ed.).

to adjust the situation between the parties, especially in view of the pending Mar-Tex suit. The existence of the Mar-Tex suit also made it difficult to find a buyer for the oil that was expected to be produced from Shamrock Island. Atlantic Refining Company had been asked to buy the oil but it at first refused. Thus, while the Mar-Tex suit might have at first seemed to be a mere nuisance suit it loomed much larger several months later as the trial date neared and as it became apparent that buyers for the oil would not be easy to find. The importance of the Mar-Tex suit is perhaps demonstrated by the fact that the jury returned a verdict in favor of Mar-Tex. In October it could well have appeared to the parties that Mel Dar might be entitled to terminate its obligations, either because the Mar-Tex threat constituted a breach of Burnett's covenant of quiet enjoyment or because the inability to find a ready buyer frustrated the purpose of the lease. Furthermore, it was to be expected that a buyer when found would want to protect itself by impounding proceeds from the oil sufficient to care for any interest to which Mar-Tex might be entitled. The effects of such an impound on the Burnetts and Mel Dar under their agreement before the amendment existed would give rise to some interesting facts. Out of every $100,000 received from production of the four planned wells $60,000 would be impounded being unavailable for use. The driller, Bankhead, would be entitled to $22,500 in payment for drilling the last three wells (the first having been paid for). Thus, only $17,500 would be left. But Mel Dar was required to pay Burnetts 25% of the gross or $25,000. In order to meet this payment Mel Dar would have to borrow

$7,500 from another source. Thus, so long as the impound remained in effect nothing from the proceeds was available to Mel Dar for servicing its debt to the bank and in addition for every $100,000 gross receipts Mel Dar would be $7,500 further in debt.

Taking all these facts into consideration there would seem to be ample business purpose for an amendment of the lease giving the Burnetts a 25% net interest rather than a 25% gross interest.

The Tax Court relied principally on the proposition that the Burnetts received no consideration for decreasing their interest, arguing that Mel Dar's forbearance to cancel the lease could not supply consideration since it had no right to cancel in view of the existence of the Mar-Tex suit at the time when the original lease was entered into in June. However, we think there was consideration to the Burnetts. There is considerable support in Texas Law for the position that Mel Dar did have a right to get out from under the lease,[5] and, even if it did not have such a right which would ultimately be upheld in court, the forbearance to cancel based upon a belief in the existence of such a right would supply the consideration. The positive existence of a right to cancel would not be necessary. All that is necessary for consideration is a forbearance of the right to cancel based on a belief in the existence of the right, and such a belief could reasonably be founded upon a more serious outlook toward the Mar-Tex suit as trial approached and the difficulty in finding a ready buyer

[5]The Tax Court in its opinion stated that "Mr. Burnett virtually guaranteed peaceful possession of the property."

for the oil. The prospect of having to pay out $7,500 more than was taken in, even though only a temporary condition (during the pendency of the Mar-Tex suit), was not an attractive one. The money would have to be obtained from some place. Furthermore, the bank had loaned large sums of money and its interest would certainly be adversely affected by Mel Dar's inability to service the debt during the pendency of the suit and Mel Dar's cash payments in excess of its receipts.

It can well be understood how the Burnetts and Mel Dar, dealing at arm's length, would desire a temporary cutback in the royalty under the facts of this case. The Burnetts under the loan agreement of Mel Dar with the bank were required to loan back to Mel Dar any funds received as royalty from production. If the Burnetts received 25% of the gross they would have to pay income taxes on that amount and then loan the remainder back to Mel Dar. During the development period it would make much more sense to leave the money with Mel Dar rather than extract it (causing Mel Dar to pay out $7,500 more than it received), pay taxes on it, and then return it to Mel Dar in the form of a loan. As Judge Learned Hand said in *Gregory*, "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury. . . ."[9]

We think that the amendment to the lease had ample business purpose. It was an amendment which was warranted by the situation albeit true that it was no unalterably required. An independent third party de-

[9]See note 5 *supra*.

veloper might well have required the Burnetts to do the same thing.

We are not dealing here with an elaborate artifice involving ghostly or collapsible corporations, fictional leases or contracts, phony sales or other transactions which lack substance. Here is not an ingenious scheme for using existing business forms as vehicles solely for the purpose of avoiding taxes. One esteemed jurist has said that the business purpose doctrine "covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."[10] If this is true the doctrine does not apply to this case where the financial position of the taxpayers was substantially altered in a real sense by the lease amendment. We think that under all the circumstances the evidence does not support a holding that the amendment was a "sham" or a "masquerade" but that it does establish that there was a business purpose to the amendment and that the *Gregory* doctrine does not apply to deprive the transaction of its tax vitality. Accordingly, we hold that the appellants should be taxed on the basis that the October 16, 1950, amendment to the lease was valid.

II

Prior to the termination of the Mar-Tex litigation the Burnetts secured the release of some impounded funds from Atlantic after executing a bond in favor of Atlantic on which the United States Fidelity and Guaranty Company was surety. The Tax Court ruled that the money received from impound was income at

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[10]Gilbert v. Commissioner of Internal Revenue, 248 F.2d 399, 412 (2d Cir. 1957) (dissenting opinion per Learned Hand, J.).

the time received."[11] The petitioners herein contend that under accrual methods of accounting the money received from impound was not income until the final termination of the Mar-Tex suit when Mel Dar became indefeasibly entitled to the money.

The Tax Court held that the income accrued when the money was released by Atlantic relying on the claim of right doctrine as first announced in *North American Oil v. Burnet*, 286 U. S. 417 (1932). In that case North American was producing oil as the beneficial owner of property owned by the United States. The United States brought an action in which it claimed to be the beneficial owner, and the United States secured the appointment of a receiver to hold onto the income pending the outcome of the litigation. The income was paid to the receiver during 1916. In 1917 the trial court ruled in favor of North American and the receiver was discharged. The accumulated funds were paid over to North American. After various appeals the litigation was finally terminated in North American's favor in 1922. The Commissioner alleged that the money which had been in the hands of the receiver was income for 1917 when received, whereas North American contended that it was income either for 1916 when made or for 1922 when the litigation was finally terminated. The Supreme Court upheld the Commissioner's contention that the income was reportable in 1917. It was not reportable in 1916 because at that time it might never have been paid to North American. And the following

[11] The Tax Court rejected the contention of the Commissioner that the money which was impounded was income as the sales were made (i.e., as it was impounded).

was given in explanation of why it was not reportable in 1922:

> The net profits earned by the property in 1916 were not income of the year 1922—the year in which the litigation with the Government was finally terminated. They became income of the company in 1917, when it first became entitled to them and when it actually received them. If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.[12]

The Tax Court felt that this case was controlled by *North American*, and we agree. There were no restrictions on Mel Dar's right to use the money. The release was unconditional (subject only to the execution of a bond), and the income was properly accrued at that time. If Mar-Tex had won and Mel Dar had been required to return the money to Atlantic, adjustments for tax purposes would have been made.

The petitioners rely on *United States v. Consolidated Edison Co.*, 366 U. S. 380 (1961), but we think that case is different from this one and that the facts of this case are more closely akin to those in *North America*.[13]

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[12] 286 U.S. at 424.

[13] In *Consolidated Edison* the taxpayer had paid a local property tax under protest and then instituted a suit for its recovery in the proper state court. The government argued that the tax accured (for deduction purposes) when it was paid and that there was a mere contingency that a portion of the tax would be refunded. The taxpayer argued that the liability for the contested portion of the tax was not admitted and that the mere payment under protest did not require accrual for tax deduc-

III

Mel Dar incurred and paid certain expenses in developing Shamrock Island during the pendency of the Mar-Tex suit. The Tax Court held that the expenses were deductible only in the year when paid, rejecting Mel Dar's contention that they were deductible at the time when the Mar-Tex litigation became final. Mel Dar argues that the expenses though paid were not accrued from a tax standpoint because the possibility existed that Mar-Tex would become liable for the expenses in the event Mar-Tex prevailed in its suit. To be consistent with our decision herein that the money received from impound was income when received, we uphold the Tax Court on this point. The expenses were properly deductible when paid not when the Mar-Tex litigation was terminated. Mel Dar became obligated to develop Shamrock Island and expenses were incurred relating to this development and the production of oil and gas. But the expenses were Mel Dar's and no one else's. The obligation to pay the expenses would always be Mel Dar's as the principal, even though Mar-Tex might become liable to Mel Dar for reimbursement in the event Mar-Tex won its suit. Mar-Tex would never become liable as such for Mel Dar's expenses. Mel Dar's liability for the development expenses which it incurred was not contingent in any way, and thus the expenses accrued when paid.

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tion purposes. The Court held with the taxpayer that the payment was not the point at which an expense accrued but rather that the expense accrued when liability for the tax was finally adjudicated by the state court. The Court relied on the "all events" test where an item is said not to accrue until all events have happened which fix the liability therefor. The Court was evidently impressed with the fact that the only way to test liabilty for the tax was to pay under protest and then sue for a refund.

IV

Mel Dar incurred certain legal expenses with respect to the Mar-Tex suit and these were claimed by Mel Dar as deductions for ordinary and necessary business expense. Mel Dar intervened in the Mar-Tex suit after Mar-Tex had obtained a favorable jury verdict. Mel Dar contends that its participation was limited to seeking reimbursement and enhancement from Mar-Tex in the event a favorable judgment was ultimately obtained by Mar-Tex. This was the so-called second phase of the Mar-Tex suit. The Commissioner disallowed deductions for those expenses on the grounds that the expenses were really those of the Burnetts and that in any event the expenses were capital in nature and thus recoverable through depletion after being capitalized but not deductible as ordinary business expense. The Tax Court did not rule on the former ground in view of its determination that the latter ground was meritorious. The Tax Court stated:

> We conclude from the record as a whole in so far as it bears upon this issue, that the Mar-Tex litigation was primarily a title suit, and that the issues of reimbursement for expenses and compensation for enhancement were only corollary and subsidiary thereto. To be sure, the jury verdict of November 1950 forced Mel Dar to actively pursue the accounting, i.e., reimbursables phase of the proceeding. Nonetheless, the primary issue was still that of title and the proceeding to determine the reimbursables a mere incident thereof. This issue (title) was still very much in the case, and was in fact eventually so resolved as to make moot all matters pertaining to reimbursement and enhancement.

We agree.

We also consider the Burnetts' contentions with respect to disallowance of their expenses by the Commissioner to be without merit for the reasons contained in the opinion of the Tax Court.

V

Mel Dar purchased private residential property at 107 Fremont Place in the Beverly Hills section of Los Angeles. Deductions for certain expenses incurred with respect to the property were disallowed by the Commissioner on the ground that they were not ordinary and necessary business expenses. The house was located across the street from the Burnetts' residence. It was rented to one of Burnetts' daughters for $160 a month, which yielded a sum in rent less than one-half the out-of-pocket cost of taxes and interest, and which yielded a sum far below the total of taxes, interest, maintenance, repairs and depreciation. Mel Dar had never before purchased private property for investment or income purposes. The Tax Court held that the property had been purchased merely as an accommodation to Burnetts' daughter in order to provide her with a bargain rental. We think this conclusion is correct and unassailable under the facts. The deductions were properly disallowed.

VI

There is another question which remains to be considered. On January 17, 1934, Mel Dar Company, the predecessor of Mel Dar Corporation, a petitioner herein, executed a five-year non-personal liability promissory note for $162,072.28 to J. W. Jameson Corporation. Pledged as collateral for the note were 16,208 shares

of Monolith Portland Cement Company, hereafter Cement, in which corporation the Burnetts held a majority interest. Various extensions of the maturity date took place. On January 28, 1938, Coy Burnett was substituted for Mel Dar Company as principal on the note. The purpose of the loan had been to enable the Burnetts to retain control of Cement and another company by buying out certain dissenting shareholders who had questioned various transactions of the Burnetts.

Mel Dar Corporation was incorporated on May 19, 1950, and on June 1, 1950, the Burnetts transferred to Mel Dar $1,000 in cash, 1,000 shares of common stock in Mel Dar Company, and 54,804 shares of common stock in Cement. The Burnetts received in return 20,000 shares of preferred and 69,800 shares of common stock in Mel Dar Corporation. Included in the 54,804 shares of Cement were the 16,208 shares that had been pledged as security for the Jameson note; thus Mel Dar took the shares subject to the as yet unpaid note.

On June 5, 1950, Mel Dar Company was dissolved and its assets were distributed to Mel Dar Corporation in exchange for the 1,000 shares of Mel Dar Company stock which had been received from the Burnetts. Among the assets received were 51,920 shares of Cement. On or about June 5, 1950, Cement common stock was quoted at $5 per share on the Pacific Coast Stock Exchange. Mel Dar carried the unpledged shares in Cement on its books at $5 per share. The 16,208 pledged shares had an adjusted basis of $66,858 ($4.125 per share), but were not carried on Mel Dar's books at any value. The Jameson note was never listed as an indebtedness on Mel Dar's books.

For purposes of computing its excess profits tax credit Mel Dar contends that the Jameson note must be included in "borrowed capital" within the meaning of section 439(b)(1) of the Internal Revenue Code of 1939, 26 U.S.C. §439(b)(1) (1952 ed.):

> 438(b) Daily Borrowed Capital.—For the purposes of this subchapter, the daily borrowed capital . . . shall be the sum of the following:
>
> (1) The amount of the outstanding indebtedness (not including interest) of the taxpayer, incurred in good faith for the purposes of the business, which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, deed of trust, bank loan agreement, or conditional sales contract. In the case of property of the taxpayer subject to a mortgage or other lien, the amount of indebtedness secured by such mortgage or lien shall be considered as an indebtedness of the taxpayer whether or not the taxpayer assumed or agreed to pay such indebtedness

The Tax Court upheld the Commissioner's determination that the Jameson note was not an "indebtedness incurred in good faith for the purposes of the business" and that therefore it could not constitute an item of "borrowed capital" for purposes of calculating the excess profits tax credit. We agree with the decision of the Tax Court on this issue and with its reasons therefor as set out in the margin.[1]

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[1] "It is first urged that the two sentences of section 439(b)(1) create separate and unrelated tests or definitions of borrowed capital. Under this theory, Mel Dar asserts that the Jameson note qualifes under the terms of the second sentence, regardless

The remaining contentions of the petitioners are without merit.

The cases are remanded to the Tax Court for proceedings not inconsistent with the foregoing opinion.

(Endorsed) Opinion Filed October 27, 1962.

Frank H. Schmid, Clerk.

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of the presence or absence of the good faith business purpose cited in the first sentence.

"We think such a construction untenable. The first sentence of section 439(b)(1), which Mel Dar seeks to avoid, expressly mentions, inter alia, a mortgage. The second sentence, referring to property 'subject to a mortgage or other lien,' must necessarily be read in pari materia therewith. Moreover, it would be absurd to ascribe to Congress an intent to permit a secured indebtedness to qualify ipso facto, while, at the same time setting forth a test of good faith business purposes for all other debts.

* * *

"It is clear that no business purpose can be related to the economic value of the mortgaged shares. The quoted price for unencumbered shares of Cement on the San Francisco Stock Exchange was $5 and all other shares of this stock acquired by Mel Dar on June 1 and June 5, 1950, were carried on its books at that value. Petitioners have failed to prove any higher figure, thus the unencumbered value of the mortgaged shares was only about one-half of the indebtedness. In addition, the dividends on this mortgaged stock were payable to the Jameson Corporation; thus, Mel Dar received neither a valuable equity nor property productive of income.

"Mel Dar next contends that the business purpose for its acquisition of the stock was to acquire control of Cement. But the purpose of the Jameson loan when originally made in 1934 was to assure continued control of Cement by Burnett, and this was effectively accomplished at that time. In June 1950 Mel Dar acquired 100,724 of the 188,164 outstanding shares of Cement. It purchased in addition 212 shares, 800 shares and 2,326 shares in its fiscal years 1951, 1952, and 1953, thus, absent the 16,208 mortgaged shares, it would never have owned a full 50 per cent of the outstanding shares. But we cannot simply assume that 50 per cent ownership or any other given percentage was necessary to control. Petitioners have failed to show that a loss of 16,208 shares would in fact spell the end of control over Cement by the Burnett interests. There is no showing that de facto control of Cement required an actual majority of outstanding shares, or that the Burnetts individually, did not

II. Judgment of the Court of Appeals.

United States Court of Appeals for the Ninth Circuit.

Mel Dar Corporation, a corp., Petitioner vs. Commissioner of Internal Revenue, Respondent. No. 17,421

JUDGMENT.

Upon Petition to Review a Decision of The Tax Court of the United States, this Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that this Cause be, and hereby is remanded to said Tax Court for proceedings not inconsistent with the opinion of this Court.

Filed and entered October 27, 1962.

III. Order Denying Rehearing.

United States Court of Appeals for the Ninth Circuit.

Excerpt from Proceedings of Wednesday, December 5, 1962.

Before: Barnes, Hamley and Hamlin, Circuit Judges.

ORDER DENYING PETITION FOR REHEARING.

On consideration thereof; and by direction of the Court, IT IS ORDERED that the petition of petitioner, filed November 26, 1962, and within time allowed therefor by rule of court, for a rehearing of above cause be, and hereby is denied.

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hold sufficient shares in Cement to offset any loss of control resulting from loss of the 10,208 shares in question.

"In summary, we hold that respondent did not err in excluding the Jameson note."

APPENDIX B.

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] Expenses.—

(1) Trade or business expenses.—

(A) In General.— All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *.

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

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In the Supreme Court of the United States

OCTOBER TERM, 1962

No. 723

MEL DAR CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In April 1950, the Mar-Tex Realization Corporation brought suit against Coy Burnett and his wife to enforce an alleged agreement by them to grant it an oil and gas lease on certain property. While the suit was pending, the Burnetts leased the property to the petitioner, a corporation owned by the Burnetts and their children. The petitioner, whose lease would be nullified should Mar-Tex prevail in the action, intervened in the suit. In August 1951, the trial court entered judgment that Mar-Tex was entitled to the lease but that the Burnetts and petitioner were entitled to reimbursement for amounts expended in developing the property. On appeal, the Texas Court of Civil Appeals reversed, holding that Mar-Tex had had no lease or contract to make a lease. That decision became final on December 17,

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1952, after the Texas Supreme Court denied a hearing.

1. During its fiscal year ended April 30, 1951, the petitioner incurred and paid substantial operating and drilling expenses in developing the property. The first question is whether those expenses accrued for income tax purposes in the year incurred and paid, as the courts below held, or only after final termination of the Mar-Tex litigation (December 1952, hence deductible in petitioner's 1952–1953 fiscal year). The asserted ground for postponing accrual of those expenses—that petitioner would have a right to reimbursement if Mar-Tex should prevail in its suit—is plainly insubstantial. Petitioner's liability to the persons performing the services was fixed and undisputed, while its right, should certain events occur, to obtain reimbursement from a third person was too contingent to be taken into account. Cf. *Dixie Pine Co.* v. *Commissioner*, 320 U.S. 516. In any event, there is no conflict. In *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, the taxpayer had contested its own liability; the effect of a right over against a third party was not involved. In the other cases claimed to be in conflict (*e.g.*, *Levy* v. *Commissioner*, 212 F. 2d 522 (C.A. 5)), the right to reimbursement was not, as here, inchoate and contingent.

2. Petitioner paid the major part of the legal costs incurred on behalf of itself and the Burnetts in the Mar-Tex litigation. The second question is whether it was entitled to deduct those expenditures as business expenses. The Burnetts, as lessors, had covenanted the petitioner-lessee's quiet enjoyment of the property, and it seems evident that, as between the

two parties, the cost of defending the Mar-Tex suit was the responsibility of the Burnetts. As the courts below held, however, the expenditures would be non-deductible capital expenditures even if properly paid by the corporation. From the petitioner-lessee's point of view, the cost of defeating Mar-Tex's suit was the cost of perfecting its own leasehold or "working interest" which it had originally acquired with notice of Mar-Tex's claim of a prior right to the lease. And costs incurred in defending or perfecting title to property are nondeductible capital expenditures. Treas. Regs. 118 (1939 Code), § 39.23(a)-15(k).

Whether petitioner should be allowed to deduct the costs incurred specifically in the separate trial had to establish the expenses for which it would be entitled to reimbursement if Mar-Tex ultimately prevailed is less clear. That, however, was but a relatively unimportant part of the litigation and there are no facts in the record on which an apportionment of the costs between the two phases could be made.

The petition for certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

October Term, 1962

No. 723

MEL DAR CORPORATION,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITIONER'S REPLY MEMORANDUM.

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PETITIONER'S REPLY MEMORANDUM.

The petition raises two important "bread and butter" tax questions:

1. Whether in the face of *United States v. Consolidated Edison Co.*, 366 U. S. 380, the mere physical payment of a deductible expense accrues it, where, prior to filing its return for the year of payment, taxpayer has secured an adjudication that it be reimbursed for such expense by another.

2. Whether an otherwise deductible legal expense resulting from a successful complaint for reimbursement of income forfeits such deducibility merely because it is tried under the same caption as a prior "title" trial.

Respondent's discussion of the first question presents merely its assertions that: (1) the case of *United States v. Consolidated Edison Co.*, 366 U. S. 380 (which ex-

pressly disapproved the authority relied upon by the Courts below) has a limited, narrow scope; and, (2) that petitioner's adjudicated right to reimbursement was "inchoate and contingent" unless later confirmed on appeal. Respondent's attempted limitation of the *Consolidated Edison* doctrine to primary liability cases ignores the long-settled rule that secondary liability of another party for the expense in question will defeat the claim of the payor for a deduction in the year of payment. *Smith v. United States*, 135 F. Supp. 694 (D.N.H. 1955); *Standard Oil Co. of New Jersey*, 7 T. C. 1310 (1946); *Estate of Elmer B. Boyd*, 28 T. C. 564 (1957). And surely, a final judgment for reimbursement (at least until reversed) is not "inchoate and contingent", even though an appeal is pending.

Respondent's "factual" discussion of the second question—the deductibility of the petitioner's legal expenses of seeking such reimbursement—is flawed by so many egregious misstatements of the record, that we are constrained to demonstrate this situation by laying such argument alongside the record and comparing them.

Respondent's Brief	The Record
". . . It seems evident that, as between the parties, *the cost of defending the Mar-Tex suit* was the responsibility of the Burnetts. As the courts below held, however, *the expenditures* would be non-deductible capital expenditures even if properly paid by the cor-	". . . *Mel Day intervened* in the Mar-Tex suit *after Mar-Tex had obtained a favorable jury verdict* [on the 'title' question] . . . *This was the so-called second phase of* the Mar-Tex suit . . . The Tax Court did not rule on the former ground" [The Commis-

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poration." (Brief, pp. 2-3.) (Italics ours.)

"From the petitioner-lessee's point of view, *the cost of defeating Mar-Tex's suit was the cost of perfecting its own title* or 'working interest' which it had originally acquired with notice of Mar-Tex's claim of a prior right to the lease." (Brief, p. 3.) (Italics ours.)

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sioner's claim that such expenses were the Burnetts' in view of its determination that the latter ground [capital expenditures] was meritorious . . . We agree." [Court of Appeals' Opinion, R. 467, 475-476.] (Italics ours.)

"The Mar-Tex suit was divided into two phases, the first [between Mar-Tex and the Burnetts] being whether there was a valid lease or contract to deliver such lease. The second phase, contingent on victory for Mar-Tex in the first phase involved the right of the defendants to reimbursement." [Tax Court Opinion, R. 196-197.]

"On November 7, 1950, the jury decided this issue [the 'title'] in favor of Mar-Tex . . . On April 30, 1951 Mel Dar intervened . . . claiming reimbursement . . . This was the second phase . . . On August 1, 1951 the court entered judgment upon the verdict for Mar-Tex . . . and judg-

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ment was entered for the Burnetts and Mel Dar holding that they were entitled to reimbursement for the $513,000 expended by Mel Dar up to that time for development.". [Court of Appeals' Opinion, R. 467.]

". . . *the jury verdict of November 1950 forced Mel Dar to actively pursue the accounting, i.e. reimbursables phase* . . ." [Tax Court Opinion, R. 233.] (Italics ours.)

"And costs incurred in defending or perfecting title to property are non-deductible capital expenses. Treas. Regs. 118 (1939 Code), §39.23 (a) — 15 (k)." (Brief, p. 3.)

Regulations 118, §39.23 (a) — 15 (k) also provide that expenses of recovering "amounts of income which, if and when recovered, must be included in income" as well as that portion of attorneys' fees in a quiet title suit properly allocable to "collecting rents" are deductible.

"Whether petitioner should be allowed to deduct the costs incurred specifically in the *separate trial* had to establish the expenses for which it would be entitled to reimbursement if Mar-

Mel Dar did not claim a deduction for the Burnetts' expenses of the first or "title" trial. Mel Dar did claim a deduction for the expenses of its successful intervention after the title

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Tex ultimately prevailed is less clear." (Brief, p. 3.) (Italics ours.)	issue was decided, which, after a second, "separate trial," resulted in a judgment for $513,000. [Stip. of Facts, R. 164-171; Tax Court Opinion, R. 208, 229.]
"That, however, [the 'separate trial'] was but a *relatively unimportant* part of the litigation . . ." (Brief, p. 3.) (Italics ours.)	The first or "title" trial occurred October 30 - November 7, 1950. The second or "reimbursables" trial occurred April 30-May 10, 1951. [Stip. of Facts, R. 122.] The final judgment, entered upon the verdict August 1, 1951, upholding Mar-Tex's title, was conditional upon reimbursement of the $513,000 development costs expended by Mel Dar. [Court of Appeals' Opinion, R. 467.]
". . . there are *no facts* in the record on which an apportionment between the two phases could be made." (Brief, p. 3.) (Italics ours.)	Respondent is confused. The ground of disallowance below, challenged herein, was not factual (lack of evidence) but legal—
	". . . All expenses of such suit are non-deductible capital expenditures, regardless of 'phase'." [Tax

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Court Opinion, R. 240-241.]

However, the voluminous evidence as to the identification of Mel Dar's expenses to the "separate" reimbursables trial [R. 164-171; Ex. 47-1 through 47-99; Ex. 48, 49] was not challenged below.

We are well aware of the pressing and competing claims upon the Court's time. However, we reiterate that the Commissioner has yet to deny that he disallows all taxpayers' claims for expense deductions pending litigation of claims for reimbursement thereof under the "all events" test. Surely, there should not be one law for the high and a different law for the low. As this Court has held from its very inception, justice is the same whether due from one man to a million or from a million to one man. *Chisholm v. Georgia*, 2 Dall. 419, 466.

The petition should be granted.

Dated: March 5, 1963.

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